

JAGLCS Practice Note

Tax Law Note

Important News for Service Members Who Sold Homes after 6 May 1997 and Paid Income Tax on Gains from Those Sales

*Lieutenant Colonel Noël Woodward
Professor
The Judge Advocate General's School, U.S. Army
Charlottesville, Virginia*

Service members who sold homes after 6 May 1997 and paid income tax on gains from those sales may be able to obtain a refund from the Internal Revenue Service; however, 10 November 2004 is the deadline for filing some of the refund claims.

Generally, capital gains derived from the sale of a personal residence are taxable unless deferred or excluded.¹ Before May 1997, taxpayers could only defer payment of tax on capital gains from the sale of their principal residence if the gains were rolled over into purchase of a replacement principal residence of equal or greater value within a designated period of time.² If they lived overseas, military taxpayers could have up to eight years to purchase new residences into which they could roll over gains and defer tax.

The Tax Relief Act of 1997³ created a significant benefit for homeowners by allowing an exclusion of up to \$250,000 of gain (\$500,000 for joint filers) from the sale of a principal residence.⁴ Because service members relocate frequently, this Act was especially beneficial to military personnel. To qualify for the exclusion, a taxpayer must have owned the home during the last five years (Ownership Test) and also lived in the home for at least two of the last five years (Use Test).⁵ The two-year Use Test need not be continuous, and the taxpayer may meet the Ownership and Use Tests during two different two-year periods.⁶ A taxpayer may generally only use the provision for one sale or exchange every two years.⁷ Finally, the sale of the home must have occurred after 6 May 1997.⁸

Many times service members retain ownership of homes after relocating and convert them into rental properties. They might eventually sell these homes without returning to live in them and would therefore fail the Use Test and not qualify for the exclusion. Until recently, no special relief was available for these service members. Last year, however, the Armed Forces Tax Council successfully obtained tax relief for service members who could not meet the Ownership and Use Tests in order to qualify for the exclusion.

On 11 November 2003, the President signed the Military Family Tax Relief Act of 2003.⁹ This Act amended Internal Revenue Code, section 121(d), to suspend the five-year Ownership Test for up to ten years of qualified extended duty for military taxpayers.¹⁰ "Qualified official extended duty" is defined as service at a duty station at least 50 miles from the property as of 11 November 2003.¹¹ "Extended duty" is defined as any period of active duty under a call or order to such

¹ See I.R.C. § 61 (LEXIS 2004).

² See *id.* § 1034 (repealed 1997).

³ Pub. L. No. 105-34, 111 Stat. 788 (1997) (codified in more than 250 new sections and included by modifications to more than 800 existing sections of the I.R.C.).

⁴ I.R.C. § 121(b).

⁵ *Id.* § 121(a).

⁶ I.R.S. PUB. 17, YOUR FEDERAL INCOME TAX FOR INDIVIDUALS (2004).

⁷ I.R.C. § 121(b)(3).

⁸ *Id.* § 121(a).

⁹ Pub. L. No. 108-121, 117 Stat. 1336 (2003).

¹⁰ *Id.* § 101(a).

¹¹ I.R.C. § 121(d)(9)(C)(i).

duty for a period in excess of ninety days or for an indefinite period.¹² The service member must elect to suspend the running of the five-year ownership period and may only make one election at a time.¹³

This change for military taxpayers applies to home sales after 6 May 1997. To obtain a refund, taxpayers normally only have three years (calculated from the due date for filing that year's return) to file an amended income tax return.¹⁴ Qualifying service members, however, who sold a residence before 2001 (for which the three-year limitations period would have lapsed), have until 10 November 2004 to amend their prior year income tax returns to take advantage of this provision and obtain a refund (with interest) for any tax paid on gains from qualifying sales.¹⁵ Taxpayers should write "Military Family Tax Relief Act" in red in the top margin of the Form 1040X, Amended U.S. Individual Income Tax Return.¹⁶

¹² *Id.* § 121(d)(9)(C)(iv).

¹³ *Id.* § 121(d)(9)(D)(i).

¹⁴ *Id.* § 6511.

¹⁵ Pub. L. No. 108-121, § 101(b)(2), 117 Stat. 1336 (2003).

¹⁶ I.R.S. PUB. 3, ARMED FORCES' TAX GUIDE (2003), available at <http://www.irs.gov/pub/irs-pdf/p3.pdf> (last visited September 16, 2004).